DOW THEORY LETTERS INC.

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36 Letters per Year – $125 Annually

Registered with the Securities Exchange Commission

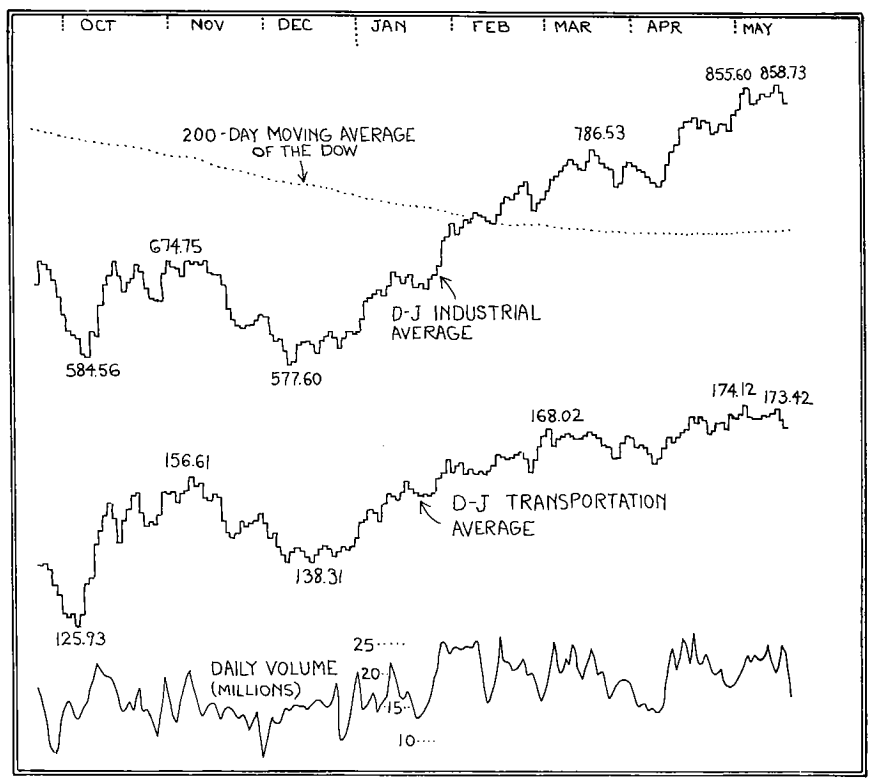
May 21, 1975 Letter 631

May 9, DJIA 850.13; PTI 322; A-D ratio -28.28
May 16, DJIA 837.61; PTI 330; A-D ratio -27.61

THE MARKET: Some months ago I commented that I have known a few men who possessed an almost uncanny ability to see the trend of coming events in both business and politics, but I have never known a man who could predict with any degree of accuracy how those events would effect the stock market. Thus, the business picture appears actually to be deteriorating further as the year moves along. Auto workers' unemployment funds are running out, new car sales are pathetic, wholesale prices edge up, Ford and Chrysler (in the face of poor sales) announce price boosts coming up on the new line, inventories are far from liquidated (due to sluggish sales), consumer credit is down for four out of five months, and on and on. Yet all this is obviously well known.

Despite what so many economists and Wall Street writers avow, the market is not an idiot. I would say that the majority of all the market movements in history left students puzzled for an explanation — at the time. In retrospect, however, it is usually seen that market moves are based on a definite logic. That logic may include over-doing it on both the upside and the downside. But then the Averages don't work according to the preconceived concepts of mathmeticians or the paths laid out for them by analysts armed with compass and ruler. The market also reflects expectations and emotions, and occasionally we will see a movement that is based almost entirely on what is "supposed to happen." For instance, the 1946 market crash and the 1962 market cave-in were predicated on a coming economic slump. But lo — in both cases the business slumps failed to materialize.

Some of today's market writers are saying that the current explosive rise is based solely on the "market's mistaken notion of a coming boom in the economy." The boom is not fated to materialize, warn these writers, and when the market realizes this, it's going to be fire and brimstone for Wall Street. I do not fancy myself an economist, but I read a good deal of what smarter men than I say about the economy. For instance, Tom Holt, in his May 2 Advisory, notes, "We submit, no amount of optimistic economic forecast can bring about an early resurgence in consumer spending. If anything, the eventual letdown of the falsely-created hopes could cause an even sharper major cutback in purchases later. Investors and consumers alike are well-advised to prepare for such an eventuality." Sharply differing with Holt is Fortune Magazine which (in May) stated that "The recession is hitting bottom now .... In the nature of so violent a decline, the economy is not going to linger long at the bottom. Recovery will begin to stir this month or next, and from there on, the trend will be up, the only question being how far and how fast."



My own feeling is that business is going to be much, much harder to "get going" than the majority of optimists now believe. In the past few Letters I stated (skeptic that I am) that I will be amazed if all those bright economists (who had no inkling a year ago about today's recession) are suddenly going to be correct about "the coming business boom" of late-1975 and '76. I think their crystal balls could fail them again during 1975-76. And I'm sorry to have to say that.

From the standpoint of my own subscribers, I have three main classifications of readers: (1) There are the traders and investors, the

 people who follow these reports because they suspect that I have something to say about the stock market which could be worth the reading. (2) There are the businessmen, those individuals who feel that Dow's Theory can aid them in their business decisions. Many of these subscribers have stocks, some have none, and still others own stock solely in their own corporations. (3) There are the students and the interested observers (and you'd be amazed at how many of these there are). These are the readers who have an academic interest in Wall Street and the economy, and they find my work (this might be just a wish on my part) stimulating or even instructive.

Of course, from the view of the pure stock market technician, the whole affair is very cold and matter-of-fact. I recently overheard a discussion between a top-chartist and a name economist. The words went something like this: Economist: "Blast it, Chartsky, the economic picture should be shaping up. The whole recovery is too sluggish, too drawn out, and I wonder if I even should have given that bullish interview to the New York Times last week. Frankly, I'm worried as all get-out, I can't sleep nights, and I've tried every pill in Rexall's."

The chartist speaks: "I told you, Econowitz, I couldn't care less about the economy. Of course, I'm sorry you're having trouble sleeping; have you tried Librium yet? Ya know, when I bought Melville Shoe and Reynolds Aluminum back in December, I was only interested in one thing — would they go up or would they go down. Personally, I don't care if they merge and start manufacturing aluminum sandals, then file for bankruptcy a month later. I'm still only interested in one thing — up or down. If they're going lower, I'll give 'em back to Wall Street, and I don't give a damn why they're going lower. So what am I, some kind of a traitor to be tried by the Financial Analysts Journal?"

Unfortunately, Dow Theory Letters isn't written solely for market technicians. Subscribers to these reports (at least a large percentage of them) want more than up or down arrows over a list of stocks. So the question immediately arises, what do I think of the overall picture as it's developing? My thoughts are as follows: I believe 1975 is going to be a dragged out affair, economically speaking, with any business recovery fated to be ragged and literally "hard to find." I think stocks have been surging higher in violent counter-reaction to the fantastic crash and technical (downside) compression of 1973-74. And I feel that stocks will move too far on the upside here in 1975 just as they sank too far on the downside in late-1974.

Following the termination of the current extraordinary advance, we will probably see a correction that will take the market back to a level where it will have protected itself against the disappointment of an economy that is still riddled with problems and troubles. Such a correction could be extended, it could be deep, or it could be both. For instance, the market crashed in 1929 and headed down for three years. The July, 1932 Dow bottom of 41.22 discounted the worst of history's most dismal depression. From that 41.22 bottom, the Dow turned up and doubled in two months (to 79.93 in September, 1932). Part of the doubling was simply technical "de-compression" or rebounding. And part was optimism, based on the thesis that the bottom had arrived, it was past, and from here on the economy would expand like a giant flower. Then reality set in.

A correction, beginning in September, 1932 took the Dow back to 51.94 in February, 1933, which meant that almost three-quarters of the 1932 gains were wiped out. That correction served to put the overly-enthusiastic traders back in their chairs again. And it served to remind investors that following a true stock market crash there is usually a long, arduous period of putting Wall Street and the economy back together again.

I would guess that we are in roughly the same kind of situation today. The road to recovery (even with Fed-inspired inflation) is going to be a hard one. The problems we are seeing today, the "unexpectedly" poor business, the stubbornness of the recession, these are the things that the market was warning about as it fell apart all during 1973 and 1974. It is one thing to say that the bottom has been seen, but it is another to say that just because the bottom is behind us, stocks and the economy should enter an unending march towards the heavens.

What is happening today on many front (I believe) will actually be good for the country in the long run. The case of New York City, in fact, may some day be known as the "Great Divide." After all, everybody knew the City was broke. They also "knew" that Uncle Sam would bail it out as soon as the dirty water reached the City's nostrils. Except that President Ford (on Treasury Secretary Simon's advice, no doubt) didn't follow the script. And we suddenly have New York grappling with reality, and a lot of individuals and banks wondering what the devil they were thinking of when they purchased Gotham's bonds.

Nostalgia is a very hot item today, because people find it pleasanter watching films about yesterday than dealing with the realities of today. And I keep telling myself, "Maybe this is it, maybe we're finally entering the period when the US is going to run headlong into the brick wall of reality — and then accept the fact that reality is there." It's that or become a sort of giant-balloon version of our British cousins overseas. And there's no doubt about it, Americans are seeing warnings of the future as they watch what's left of the once-mighty British Empire as it sinks into that never-never land just beyond the horizon.

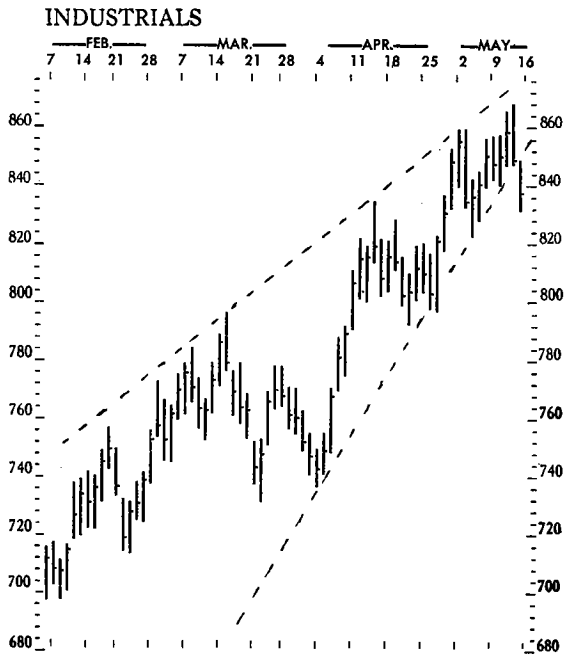
THE MARKET: For the benefit of newer subscribers I want to repeat that I follow any number of technical indicators, but I always (in orthodox Dow Theory fashion) give precedence to the Averages. Accordingly, please refer to the daily chart of the Dow Industrials and Transports (only closing prices are considered) on page 1.

On May 5 the two Averages recorded 1975 highs, Industrials at 855.60, Transports at 174.12. A minor decline ensued, followed by a renewed rally. On May 14 the Industrials recorded a new 1975 high of 858.73. The new Industrial peak was not

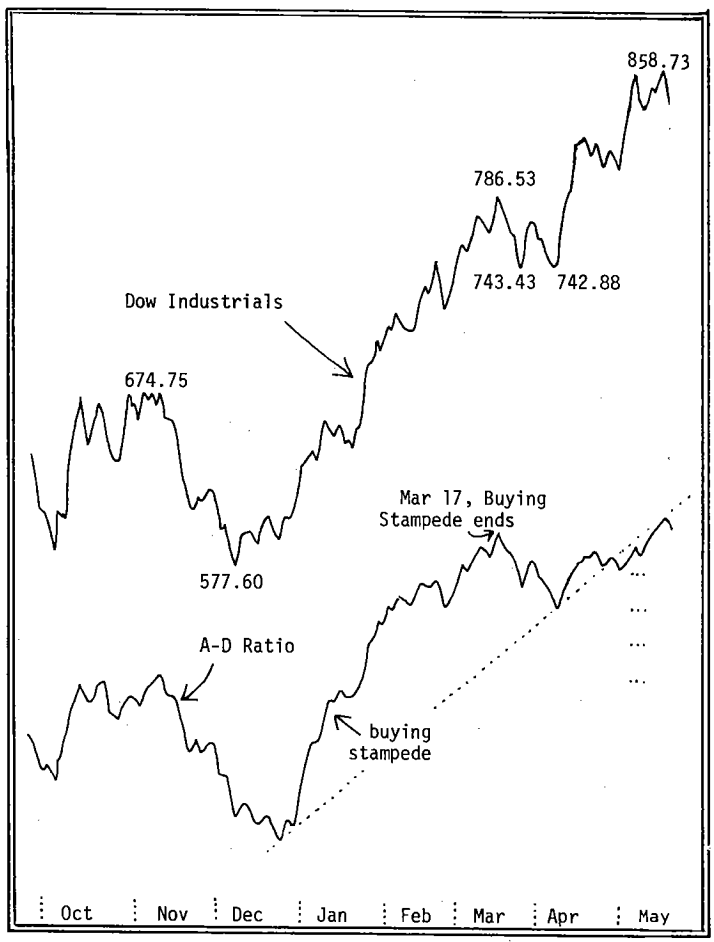
confirmed by the Transports. The carriers closed the day at 173.42, one point below their preceding high. This indecisive action was immediately followed (May 15) by a sharp break in the market with Industrials down 10 points and Transports down over 3. The week ended (Friday, May 16) with an 11-point drop in the Dow.

With the appearance of any weakness (particularly after an extended advance), the obvious question is "Could this be it? Is this a secondary correction?" And the answer is that no one but the "top experts" and the liars know. But I have stipulated in recent Letters that each new upward confirmation during a major advance possesses less validity than the last. Finally, there will be an upside penetration by both Averages which will be the last one for that particular rise — and the correction will then arrive.

Note on the page 1 chart that the 200-day moving average of the Dow is now at 696. That means that at the May 14 peak of 858.73 the Dow was 23% above its own moving average. My experience indicates that anytime a stock or an average rises around 25% or more above its 200-day MA, conditions are ripe for a correction, regardless of the long-term trend.



Also of interest here (see insert from the Wall Street Journal) is the pattern of the Dow Industrial Average. The two trendlines describe what is known in technical terms as a "rising wedge." Such formations usually imply a gradual drying up of buying power, with the sellers taking over as and when the price falls through the lower trendline. A downside penetration of the wedge occurred on May 16, and I thought this was interesting enough to bring to the attention of subscribers.



On May 9 the advance-decline ratio, following two months of backing and filling, pushed above its March 17. This action constituted a belated confirmation of the Dow, but ironically, no sooner did the A-D ratio confirm than the Dow turned reactionary. That the general market, as measured by the A-D ratio, has lost much of its lifting power can be seen by the fact that the A-D ratio (despite the May 9 upside confirmation) has broken its main trendline (which connects the December and April lows).

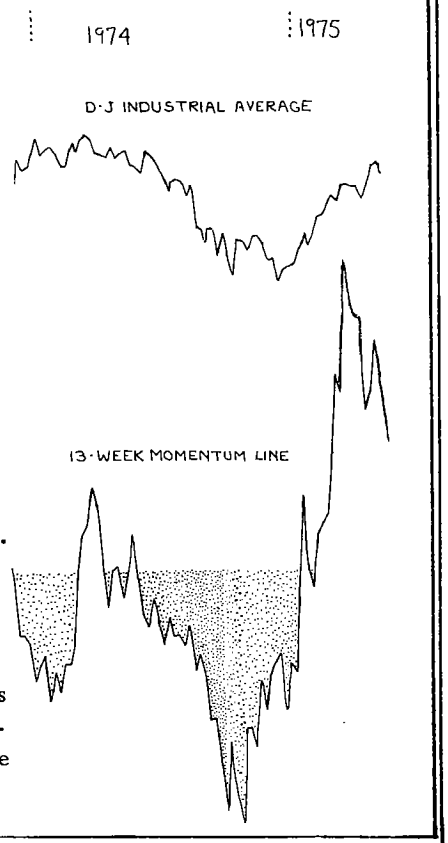
As far as tactics are concerned, I want to repeat that a bull market deserves every benefit of the doubt regarding upside potential. Bull market reactions are tricky, deceptive, and exceedingly difficult (if not impossible) to predict in advance. Therefore, I will simply say again that my own inclination is to watch the show with a good portion of my wares on the sidelines. Each man has to wrestle with his own ghosts and goblins in this business, and my personal inclination is not to ask the market for any "favors" at this point. After a 281 point rise in the Dow, I feel it is asking a favor of the market to insist that it plow up from here. This, of course, doesn't mean that I'm a bear on stocks or on America. It simply means that I value my sleep more than I do potential profits from here (but I'm ready to turn intermediate-term bullish on any good correction).

TREASURY NOTES: I was surprised by the amount of interest the Treasury note comments (see last Letter) brought in. Many readers are asking for more, so here goes. First, I want to repeat something I read years ago, written by the Financial Editor of

the now-defunct New York Herald Tribune. The Editor wrote that young people do not understand the amazing capital-building power of compound interest through time. Therefore, he said, instead of going into debt when they are young (and allowing compound interest to work against them, they should save whatever they can, put that money to work for them and let compound interest work for them through the years. I would say that this is one of the most important lessons anyone can ever learn about handling money and building capital. Money plus interest through time builds fortunes.

Before I forget it, Union Carbide offers a booklet (free) on interest tables. You owe it to yourself to write for this booklet and to study it (write for "Compound Interest Tables," Union Carbide, 270 Park Ave., New York NY 10017).

DOW MOMENTUM: I reviewed the Dow momentum indices in Letter 629, and I stated at the time that the 13-week momentum line (ratio of the Friday Dow close to its comparable closing value 13-weeks ago) had probably topped out. I also wrote that we should watch for a downward zig-zag in the momentum index that would tell us that the Dow momentum was breaking down. At last Friday's close (May 16) of 837.61, the 13-week (intermediate) momentum index fell to 114, thereby forming a major downward zig-zag as seen on the chart. This is the lowest momentum level since February 14, 1975. Although Dow momentum is still well into the positive momentum area (above 100), the fact is that corrective forces are now exerting pressure on the Dow (note: the shaded sections of the momentum index indicate negative momentum or areas in which the index is below 100).



In the last Letter I wrote about the interesting advantages in purchasing Treasury notes (which technically are Treasury debt instruments maturing in one to seven years), and I recommended the Treasury 7 3/4's of 1981. This is a note which matures six years from now in 1981, has a coupon (pays twice a year, May and November), and at current prices provides a yield of about 7.7%. The note is backed by the full assets and taxing power of the US Government.

Why do I like the Treasury notes? First, (as I've been saying), I feel that the US economy is still in trouble, and that it could get worse before it gets better. I think you can write off 1975 as a disaster year for the auto business, and I think at best 1975 is going to be a very poor one for housing. Retail sales are barely holding their own, and I see no consumer buying boom in 1975. The Government (so far) has been making some attempt to hold down spending (as per New York City, for instance), and they may do a fair job of this for a while. Meanwhile, the real spendable income of Americans has dropped over 5% this year, and this is hardly calculated to be a spur to economic expansion. Finally, with unemployment holding at a high level and the much-promised business upturn still not visible, the consumer is going to be hesitant to spend us out of recession. In other words, I don't go along with the economists who think 1975 is the year of the big upturn. I think the tax rebate could bring about a little flurry in spending and that's about it. All of which will mean disappointments for business (which is cutting back expansion plans) and for the public (which is paying off its installment debt as fast as it can).

So my first contention and contrary opinion is — no big business upturn in 1975. My second contrary opinion is that there will be no "crowding out" in the money markets. I think that the corporations will not be crowded out by huge Government financing (as so many have predicted), but instead another problem will materialize. The problem is going to be fear of bankruptcies and a move by investors to the best and safest form of debt instrument. That instrument, of course, is the debt of the US Government. I have favored the US Treasury bill (any maturity of less than one year), but I now favor the Treasury note (maturities of over one year but up to seven years).

Next contrary opinion: the bond market (or at least the Treasury sector) is heading up. The biggest, safest play for the remainder of 1975 is not going to be the stock market, it is going to be the Treasury market. Why do I say this? Because stocks have already made a major move, a move which most of my subscribers caught (we rode the broadest and safest portion of it). But now I feel that the investment play is in Treasury paper. Here, the investor can buy medium-term paper that guarantees a 7.7% yield over the next four, five, six or seven years.

My feeling is that sluggish US business throughout 1975 is going to result in a gradual build-up in liquidity. Seasoned investors, noting that most corporations are having a hard time of it, are going to move out of many stocks, out of lesser quality bonds, out of Municipal bonds (the New York City situation is casting a pall over the whole Municipal bond situation) and into the safety slot. And the safety slot I'm talking about is the safest of all debt vehicles, US Treasury debt. The wealthy investor surveys the stock market, he sees the Dow up over 50%, he sees a yield of 4.1% on Standard & Poor's broad 500 stock Average, he sees almost double that yield on Government notes, and he sees the risk-reward heavily in favor of the notes.

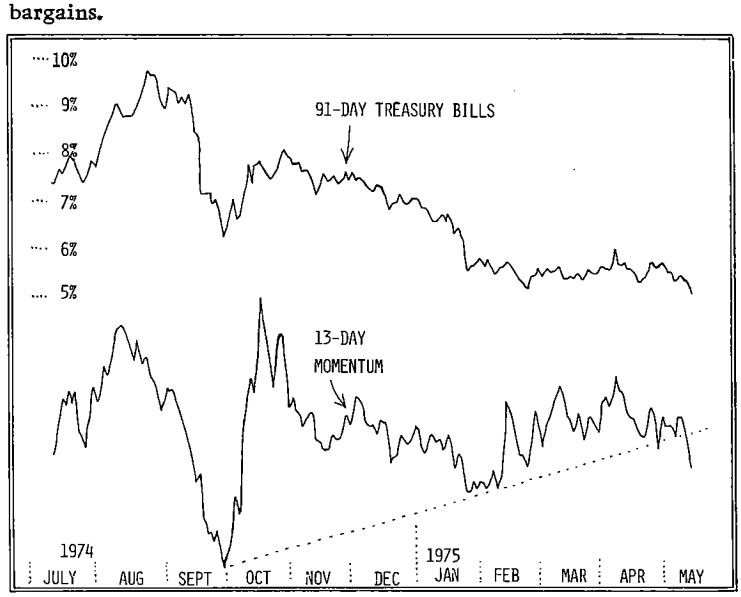
And what about the risk in buying the notes? If interest rates do drop as business continues poor and as liquidity floods the market, the 7.7% yielding notes could drop to yields of 6% or even lower. There could be a rise of 5% or even more in Treasury paper. Couple that with a yield of 7.7% and you have a potential gain of 12% or more on Treasury notes. All right, say I'm wrong, say the economy actually picks up in 1975 and interest rates work higher. Then we're "stuck" with a super-safe piece of Treasury debt that pays us 7.7% a year until 1981. We sit and collect our interest (and that, readers, should be the worst mistake you ever make in your investment career). Or as I told a few friends, 7.7% for the next seven years is probably better than the average investor or institution is going to do.

The question immediately comes up, "What about margining the notes?" Well, you can buy Treasury notes on only 10% margin, which is always tempting, but I don't recommend margin. I don't recommend margin because at that point the investment becomes a rank speculation rather than an investment. I always prefer the latter, and the men I know who have made real money in the securities field have, for the most part, been investors, not speculators. A big margin account is like a position in a near-term option; you may have picked the right stock or bond, but you are at the mercy of another variable. If you have the big margin (speculative) position, a market fluctuation can wipe you out even though you are correct on the long-term trend. If you have the near-term option position, time can wipe you out, since the move may start in earnest after your option expires.

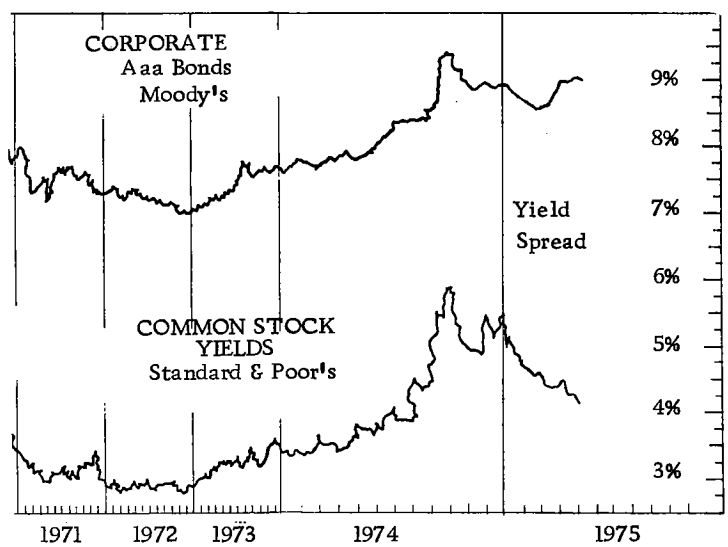
Question: What if the notes go up fast over the next few months, what do I do then? Answer: I might advise selling them and taking a profit. I'd have to see. Question: Won't inflation hurt the Treasury notes and the whole bond market? Answer: Yes, but I think the temporary forces of poor business are going to bring on enough deflation to countermand the long-term inflationary forces, at least through 1975.

Question: Wouldn't I be better off just holding stocks in this bull market? Answer: Perhaps, but if this market continues up without a correction the risk-reward for holding stocks will steadily diminish. In that case it is a question of "Where is an intelligent alternative to place one's funds?" At this point, I feel that the most intelligent alternative is the T-note market. Before 1975 is out, today's Treasury yields could look like bargains.

Question: How about T-bills or T-Bonds at this time, rather than T-notes? Answer: The T-bills mature too soon. Locking in a current T-bill yield of 5% doesn't mean anything at this point. You would have to worry about re-investing all over again in three months or six months. On the other hand, the notes lock in a fat yield for six or seven years. Bonds' maturities of ten years or more are too far off for our purposes. For this reason, I would avoid them. If the notes go against us (decline), we can collect 7.7% and if need be wait for maturity, and it's no catastrophe sitting for seven years at interest rates of over 7%. But who's going to wait out a mistake of 15 to 30 years? And that's the way the seasoned money thinks.



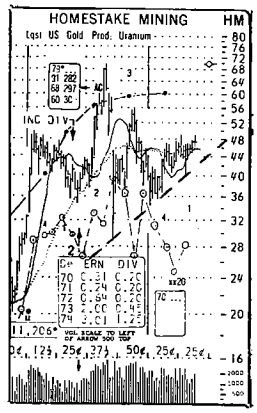
I want to present a few chart illustrations at this point. The first is a chart from the latest issue of The Money Manager (formerly the Bond Buyer). The chart shows the current whopping 4.83 yield spread in favor of bonds over common stocks. At 4.13% yield, the S & P 500 would have to better than double average dividends to pay the 8.96% yields provided by Moody's Aaa rated bonds! Unless you can prove that inflation is rampant (which it now is not), there is too much of a spread in favor of bonds (which means that either stocks are too dear or bonds are too cheap). If you measure the yield spread you'll see that it is now greater than the spread that existed in January, 1973 at the 1051 peak for the Dow.



The second chart shows the bellwether of short-term interest rates, the 91-day Treasury bill (it matures in three months). This daily chart follows the path of the 91-day bills (they are always referred to in terms of yield, not price) from the fabulous 9.5% yield peak of August, 1974 to the recent 1975

lows just above 5%. In other words, over the past nine months the yield on the T-bills has literally dropped in half. This dramatic drop in yields is a function of Fed policy towards easier monetary conditions plus a drop in business loans and an abrupt lessening of inflationary forces.

But what I want to bring to the attention of subscribers is the event of last week. On Monday, May 12, the 13-day momentum line for the bill yields broke below an eight-month rising trendline. This move, I feel, is very important, and it suggests that short to medium term Treasury obligations may be dropping to lower yields than any seen in many months. If the T-bills sink well below 5% yield, then investors will probably move out into T-notes in order to get higher yields. This process could drive the note prices up (and yields down, of course), and it would not surprise me to see T-note yields in the low to under 7% yield area during the second half of 1975.

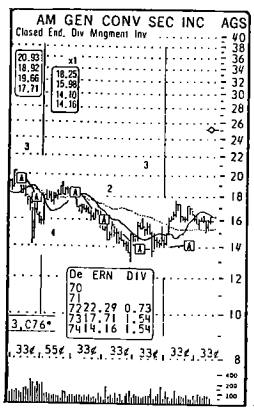


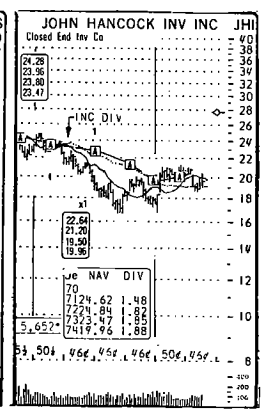
GOLD: I wrote in Letter 629 that gold bullion seems to have lost much of its volatility and momentum on both the upside and the downside. The rise in gold momentum (the last bull cycle) from July, 1974 to January, 1975 was sluggish. The momentum drop from January to the present was also sluggish. Gold momentum (13-week ratio) has been almost motionless for the past five weeks. Bullion seems immune to all news, and I continue to believe that the great bullion rise from $35 in 1971 to $195 in 1975 (up 457%) discounted an awful lot of inflation.

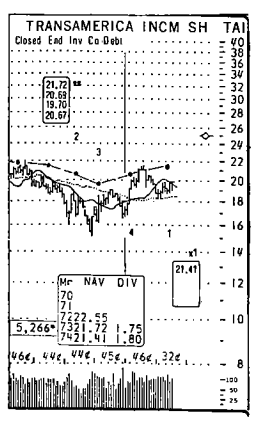
Homestake (as I suggested in the last Letter) is acting considerably better than the S. African or Canadian shares. The gold group is not acting bullishly on a relative strength (RS) basis, and I always hesitate to recommend any stock or group when it is not acting better than the market. My chart of Homestake shows that it hit an RS low in mid-April, and RS has been climbing higher since. A rising trendline in HM connects the September, December (1974) and April (1975) lows. The trendline is now at 42.

For those who feel more comfortable with a gold hedge, I would hold your total gold commitment to 15% of assets with part in Krugerrands and part in Homestake. I can't prove it, but I feel that the simmering S. African racial situation (and don't tell me it's not simmering) is a long-term depressant on these issues. By the same token, the rising socialism of Canada is a continuing depressant on the Canadian issues (and this is particularly true of mining issues). Note: A recent article in Dunn's Magazine interviewed tycoon Floyd Odlum. He is of the opinion that uranium is the fuel of the future. I agree. Maybe that is why Homestake (which is deriving an increasingly large share of its income from uranium) is acting better than the other gold shares.

STOCKS: Since I've been talking about income stocks and they seem to be of great interest to many subscribers, I want to continue in this vein (yes, I know about inflation, but I don't see any real inflation for 1975 the way things are moving). First, there are the open end bond funds, funds that hold bond portfolios even though these funds trade exactly like stocks on the NYSE. I think John Hancock (see chart) is interesting and well down from its high of 28. At 20, with dividends of $1.88, this fund yields 9.4%. I also like Transamerica Income Fund which was as high as 25 and is now 20. With dividends of around $1.80, this fund yields 9%. For the more venturesome, there is the lower quality American General Convertible Security Fund which holds convertible securities including bonds and preferred stocks. AGS was as high as 25, now sells around 15 3/4, and pays $1.32 a year with occasional extras (without the extras we have a yield here of 8.3% plus the convertible feature which tends to move the stock up or down with the market — however, the current high yield should put the brakes on the downside from here on).







Of course, an advantage of the bond funds (most pay monthly dividends) is that they are diversified and therefore offer a good degree of protection against any individual bond failure. One more thing — I often wonder why more people aren't aware of the Amer. Tel $4.00 convertible preferred, a stock convertible into 1.05 shares of Telephone common and now just about on conversion. The Tel. conv. pref. offers a yield today of 7.65%, is probably safer than most bonds, and yields 10% more than the telephone common. (Charts courtesy of Quote, PO Box 213, Wichita KS 67201).

LATE NOTES: The market opened the week (Monday, May 19) on the downside with many of my leading indicators breaking or near-breaking. My strongest single index has been the cumulative most-active stock index on the NYSE, and this is still holding (I'll try to cover this in the next report). Often, the strongest index is the place to watch when the market turns reactionary. The 20-most active stock pluralities have been plowing up since last October, leading the market. Count those pluralities each day. If they turn weak, I feel we're going down. Also, watch the Dow. If we come down to around 800, then rally we'll have a potential head-and-shoulders top in the senior Average (you can visualize this on the page 3 chart of the Dow).